UPSET PRICES IN CORPORATE REORGANIZATION

THE uncertainties, delay, and heavy expense involved in corporate reorganization, particularly where dissension arises among the security holders, would seem to indicate a defect in our law of corporations. The right of the majority of the stockholders of a corporation to control the corporate policy is, obviously, one of the salient reasons for the wide adoption of the corporate form in business; yet, conveniences of financing have brought about a change in the organization of corporations to which the law has not yet adjusted itself. The theory of the law is that the ownership of a corporation is vested in its stockholders; the truth is that to-day the substantial ownership of most large corporations, particularly public, service corporations, because of the lower cost of financing through the sale of bonds, is held not by the stockholders but by the bondholders. Most public utility bonds, as well as the secured obligations of many private corporations, are issued without any intent of being repaid; the money obtained therefrom is considered part of the capital invested.[1] Bondholders, unlike stockholders, stand in the position of tenants in common; in theory the consent of all the bondholders, not merely of a majority, is required before any action can be taken. So, whenever a corporation encounters difficulties, and the control of the corporation passes out of the hands of the stockholders, whose equity in the property has faded away, into the hands of the owners of the property, the bondholders, there is no convenient or facile procedure — no means of majority control — whereby the interests of the bondholders, or of other creditors, can be adjusted. Hence the confusion and litigation which accompanies a hostile reorganization.

Indeed, a corporate reorganization is looked upon commonly as a catastrophe; few recognize it as a natural phase of corporate growth. It has been estimated that fifty per cent of our American corporations have passed through some form of reorganization

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[1] See Wilds *v.* St. Louis, etc. R., 7 N. E. 290, 293, 102 N. Y. 410 (1886).

in the last twenty years.[2] Corporate reorganizations, of course, are usually caused by insolvency; but not infrequently a sound enterprise, earning an adequate return, will be hampered by an unsound financial structure involving excessive fixed charges, such as bond interest; or again, the difficulty of refunding a matured bonded indebtedness during a time of financial stringency, or the urgent need of additional capital for improvements, or the weight of an unfunded debt, will make a reorganization necessary. Reorganization, in brief, must be viewed as a normal phase of corporate life; the frequency of reorganizations makes it necessary for the law to provide a facile procedure; and the basis of such procedure must be fair majority control. It is the purpose of the writer to indicate how this right of the majority to control during corporate reorganizations, under the guidance of the court, can be conveniently secured without the violation of any constitutional rights, thus removing many of the present uncertainties, and much of the delay and cost of corporate reorganizations; and also to show how the authorities, throughout the various phases of corporate reorganization, are slowly recognizing this right of fair majority control.

I

The English procedure of "Arrangements" — such is the apt term used — approaches closely the desired procedure. The control of the majority over the minority, during the reorganization of public service corporations, is fully established by Act of Parliament. Formerly an Act was passed for each reorganization, and that is the practice in Canada to-day;[3] a general statute in England,[4] however, provides for all such situations, leaving it to the courts to pass upon the fairness of the reorganization plan instead of Parliament itself. Lord Cairns has tersely described the purpose of this act as follows:

[2] United States District Judge Hough, of the Southern District of New York, as quoted by Paul D. Cravath in "Reorganization of Corporations," STETSON, LYNDE, *et al.*, SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, 154.

[3] Canada Southern Ry. *v.* Gebhard, 109 U. S. 527, 534 (1883). See Jones *v.* Canada, etc. Ry., 46 U. C. Q. B. 250, 261 (1881), where Osler, J., said, in discussing such statutes, " . . . Legislation of this kind, of which, be it said, our books are full." See also, JONES, CORPORATE BONDS AND MORTGAGES, 3 ed., § 617.

[4] Railway Companies Act, 1867, 30 & 31 Vict. c. 127.

"Hitherto such companies, if they desired to raise further capital to meet their engagements, have been forced to go to Parliament for a special Act, enabling them to offer such advantages by way of preference or priority to persons furnishing new capital as would lead to its being obtained. And Parliament, in dealing with such applications, has been in the habit of considering how far the arrangements proposed as to such new capital were assented to or dissented from by those who might be considered as the proprietors of the existing capital of the company, either as shareholders or bondholders. The object of the present Act . . . appears to be to dispense with a special application to Parliament of the kind I have described, and to give a Parliamentary sanction to a scheme filed in the Court of Chancery, and confirmed by that Court, and assented to by certain majorities of shareholders and of holders of debentures and securities *ejusdem generis*." [5]

Under the English Act, the directors of a corporation in difficulty file a scheme of arrangement with the Chancery Division of the High Court. The filing of the scheme gives the court jurisdiction to enjoin actions against the Company. The assent in writing of three-fourths in value of any class of security holders, other than common stockholders, binds the minority members of each class; in the case of common stockholders the assent of the corporation at a special meeting is sufficient. The court ascertains whether a majority in each class has assented, and whether the scheme is fair and just to all concerned; if the court approves, the scheme is enrolled and becomes effective as an Act of Parliament.[6] After enrollment no appeal is possible, although the court may in its discretion delay enrollment to allow an appeal.[7] Similar procedure is provided for in the case of most private corporations under the Companies Acts.[8]

An English debenture upon a railroad's properties, or upon the property of any public utility, differs, it is true, from the ordinary American bond issue in that the rights of the security holders are limited solely to the returns [9] from the property after the fashion

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[5] Cambrian Railways Company's Scheme, L. R. 3 Ch. App. 278, 294 (1868).

[6] Railway Companies Act, 1867, 30 & 31, Vict. c. 127, §§ 6–22. See also 2 LINDLEY ON COMPANIES, 6 ed., 1261; HAMILTON'S COMPANY LAW, 3 ed., 525.

[7] Devon & Somerset Ry. Co., L. R. 6 Eq. Cas. 615 (1868).

[8] Companies Act, § 120, 8 Edw. 7, c. 69. See also HAMILTON'S COMPANY LAW, 3 ed., 527.

[9] Bowen *v.* Brecon, etc. Ry., L. R. 3 Eq. Cas. 541, 547 (1867).

of a "Welsh Mortgage" or the "*vivium vadium*" of Lord Coke;[10] but that does not affect a comparison with the English procedure of "arrangements." The public utility, under a debenture, to use the often-quoted phrase of the English courts, is viewed "as a fruit-bearing tree, the produce of which is the fund dedicated by the contract to secure and pay the debt;"[11] or, as the English courts also state it, the "living and going concern thus created by the Legislature must not, under a contract pledging it, as security, be destroyed, broken up, or annihilated."[12] In brief, a debenture holder cannot destroy the usefulness of the property to the public in order to get payment of his obligation. This same rule applies in America. A public utility is charged with an obligation to the public; its property is dedicated to the public use, and the owner thereof, or the holder of any lien thereon, cannot so change the nature or condition of the property as to interfere with the public's rights.[13] Thus in substance there is no difference between an American bond or an English debenture, and the situation in each case during reorganization is comparable.

The method of "Arrangements" in force in England, thus recognizes the two fundamental necessities of all reorganizations: first, a means of forcing the minority to abide by a plan of reorganization acceptable to the majority; second, a method of de-

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[10] See 4 KENT. COM., 6 ed., 137.

[11] Lord Cairns in Gardner *v.* London, Chatham & Dover Ry. Co., L. R. 2 Ch. App. Cas. 201, 217 (1867). See also Marshall *v.* South Staffordshire, etc. Co., [1895] L. R. 2 Ch. D. 36.

[12] Gardner *v.* London, Chatham & Dover Ry. Co., *supra.*

[13] Munn *v.* Illinois, 94 U. S. 113, p. 126 (1876). The question as to whether or not one voluntarily engaging in a public service can voluntarily withdraw on due notice to the public is not entirely settled in America. In Munn *v.* Illinois at page 126 this right to withdraw was recognized; see also Weems Steamboat Co. *v.* Peoples Co., 214 U. S. 345, 356 (1909). Yet, as a practical question, a utility, needed by the public will not be allowed to cease serving the public, and this rule now insisted upon by State Regulatory Bodies probably will be finally accepted by the courts. Moreover, a utility must give adequate service; a partial withdrawal resulting in inadequate service or a temporary cessation of service will not be allowed. San Antonio St. Ry. Co. *v.* Texas, 90 Tex. 520, 39 S. W. 926 (1897). The public has an established right in every reorganization, Central Trust Co. *v.* Missouri K. & T. Ry. Co., 246 Fed. 154, 156 (1917); and, even assuming that the bondholders could acquire the ownership of a property and completely terminate its continuance in the public service, yet they could not by reason of their position as creditors or owners, impair its usefulness so long as it continued in the public service. Thus the powers and security of holders of American public utility bonds is actually no greater than that of holders of English debentures despite frequent assertions to the contrary.

termining, preferably by the decree of the Chancellor, that the plan is not fraudulent or unduly oppressive as to minority interests. In America, although such procedure would not be a violation of the due process clause of the Federal Constitution, as to the rights of the minority, since it can be viewed as a form of bankruptcy or insolvency procedure, nevertheless, the contract rights of the minority would be impaired. The Supreme Court of the United States has so viewed the English procedure:

"Unless, as is the case in the States of the United States, the passage of laws impairing the obligation of contracts is forbidden, we see no good reason why such provision may not be made in respect to existing as well as prospective obligations. The nature of securities of this class is such that the right of legislative supervision for the good of all, unless restrained by some constitutional prohibition, seems almost necessarily to form one of their ingredients, and when insolvency is threatened, and the interests of the public as well as creditors, are imperilled by the financial embarrassments of the corporation, a reasonable 'scheme or arrangement' may, in our opinion, as well be legalized as an ordinary 'composition in bankruptcy.'" [14]

Because of this constitutional difficulty, reorganizations in America require a foreclosure sale under the mortgage or trust deed securing the bonds. Thus the procedure adopted unfortunately is that of the winding up of a business, or a complete change of ownership — a flat contradiction of the real purpose of a reorganization, which is simply an "arrangement" whereby a new financial structure can be established.[15] Such a foreclosure sale, in short, is a device rather than a fact. A new purchaser with sufficient means to buy the property outright and pay off the bondholders practically never appears; the old security holders must be the purchasers under the foreclosure sale.[16] Consent decrees are entered by the court if all the bondholders reach an agreement; and, as will be pointed out later, the courts, recognizing such consent decrees of sale to be merely devices to facilitate reorganization, rather than the adjudication of rights, do not hesitate to set aside such decrees, often with startling results. For convenience, outstanding bonds may be paid to the master under the foreclosure

[14] Canada Southern Ry. Co. *v.* Gebhard, 109 U. S. 527, 535 (1883).

[15] Canada Southern Ry. Co. *v.* Gebhard, *supra*. See 4 COOK ON CORPORATIONS, 7 ed., § 889, pp. 3496, 3498.

[16] Investment Registry Limited *v.* Chicago & M. E. R. Co., 212 Fed. 594, 609 (1913).

sale as part of the purchase price. "It is not deemed proper and necessary to require purchasers to put up cash with one hand to take it down with the other,"[17] as one court has said. And in such sales, the vital and controlling feature, although this has not yet been recognized to be the fact, is the tendency of the courts to fix an upset price as a minimum at which the property can be bought in by the majority bondholders so that the minority may not receive a sum less than the value of their bonds.[18] Our courts, particularly the lower federal courts, have adopted this procedure because they felt that the theory of a public sale under foreclosure was unsound, and that there would be no competitive bidding. Therefore they desired to protect the minority from being despoiled by the majority who could "chill the sale,"[19] *i. e.* bid the property in for a pittance and give the minority bondholders nothing.

But the American courts have gone much too far in this solicitude for the interests of the minority. The fixing of an upset price to protect minority bondholders means the intervention of the court at the controlling moment of a reorganization with the purpose, or result, of defeating the control of the majority. If the plan of reorganization is approved by the majority of the security-holders of all classes; if it appears fair and just to the court after full hearing of the contentions of the minority; and if the plan be open to the dissenting bondholders on an equality with the majority, the court should refuse to fix an upset price, or should fix a purely nominal price, disregarding the value of the property, and solely in order to take care of the mechanics of determining the value of the bonds of the majority turned in to the master as payment for the property. Thus the majority could force the minority to accept their plan of reorganization by buying the property up for an insignificant sum, and offering the minority the alternative of taking virtually nothing in cash, or of taking new securi-

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17 Schuler *v.* Hassinger, 177 Fed. 119, 126 (1910). See also Easton *v.* German-American Bank, 127 U. S. 532, 539 (1888); Duncan *v.* Mobile, etc. R. R., 3 Woods (U. S.) 597; 8 Fed. Cas. 25, 27 (1879); Rumsey *v.* People's Ry., 154 Mo. 215, 55 S. W. 615, 626 (1899).

18 See, as to the practical phases of the upset price, James Byrne, "Foreclosure of Railroad Mortgages in the United States Courts," in STETSON, LYNDE, *et al.*, SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, 141.

19 See JONES, CORPORATE BONDS AND MORTGAGES, 3 ed., § 618.

ties on an equality with the majority under the reorganization plan. The recognition of this right in the majority, and the refusal to fix an upset price, will make possible the same facile and expeditious procedure as is found under English "Arrangements," without unwise imitation of English methods and consequent violence to our American procedure, and also without the denial of any constitutional rights.

II

The Supreme Court of the United States [20] has recognized the validity of a reorganization effected under this precise plan. Indeed, Chief Justice Waite, who wrote the opinion in the Shaw case, as appears from his opinion in the Canada case, was an admirer of the English method of "Arrangements" and recognized fully the necessity of majority control in corporate reorganization. In this case the railroad company had issued two series of bonds; one for $3,500,000 secured by a mortgage on the uncompleted railroad; a second issue of $5,000,000 secured by a mortgage of its federal land grants. Upon the insolvency of the railroad company the trustees brought foreclosure proceedings; a committee representing the holders of $6,097,000 of the bonds bought in the property at the foreclosure sale for the nominal sum of $50,000 and incorporated in the decree confirming the sale a stipulation allowing all bondholders to participate on an equality in the reorganization by receiving stock in the new company. After confirmation of the sale, minority bondholders sought to set it aside; this the Supreme Court refused to do, saying by Chief Justice Waite:

"To allow a small minority of bondholders representing a comparatively insignificant amount of the mortgage debt, in the absence of any pretence even of fraud or unfairness, to defeat the wishes of such an overwhelming majority of those associated with them in the benefits of their common security, would be to ignore entirely the relation which bondholders, secured by a railroad mortgage, bear to each other. Railroad mortgages are a peculiar class of securities. The trustee represents the mortgage, and in executing his trust may exercise his own discretion within the scope of his powers. If there are differences of opinion among

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[20] Shaw *v.* Railroad Co., 100 U. S. 605, 611 (1879).

the bondholders as to what their interests require, it is not improper that he should be governed by the voice of the majority, acting in good faith and without collusion, if what they ask is not inconsistent with the provisions of his trust." [21]

The same court [22] considered a somewhat similar question some seven years later, and took an even more advanced view. Here the trustees under two mortgages on the same railroad property were following the desires of the majority of the bondholders under each mortgage in bringing about an immediate sale of the property so as to enable a reorganization to be carried out, and were seeking to have disputes, as to the priority of liens, postponed until after the foreclosure, and determined upon distribution of the proceeds of the sale.

Chief Justice Waite said, in delivering the opinion of the court upholding the acts of the trustees:

"As a rule the trustee of a railroad mortgage represents the bondholders in all legal proceedings carried on by him affecting his trust to which they are not actually parties. There is here no evidence to show fraud or unfairness on the part of the trustees. The company is satisfied with what they are doing, and so are all the bondholders under the Rawle mortgage and a majority of those under that to Devereux. As was said in *Shaw* v. *Railroad Company*, 100 U. S. 605, 612: 'Railroad mortgages are a peculiar class of securities . . .' Here the majority want an immediate sale. In this the trustees both agree, as does the railroad company itself. There is no evidence whatever of a want of good faith in any one. The court below, having the practical workings of the receivership under its own eye, did not hesitate to say that 'it is now entirely clear that the best interests of all parties concerned will be promoted by a speedy sale,' and we see nothing to the contrary."

The Supreme Court of Errors of Connecticut [23] has followed these decisions of the Supreme Court. A minority bondholder sought to enjoin a foreclosure sale and reorganization from being carried out without his consent. The court trenchantly said of the plaintiff's rights as a minority bondholder to insist upon the necessity of unanimous consent:

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[21] Canada Southern R. Co. *v.* Gebhard, 109 U. S. 527, 532 (1883).

[22] First National Bank *v.* Shedd, 121 U. S. 74, 86 (1886).

[23] Gates *v.* Boston & N. Y. Air-Line R. Co., 53 Conn. 333, 342, 345, 5 Atl. 695, 698, 701 (1885).

"In making this claim the plaintiff ignores, or subordinates to his own claim, both the private rights of his co-bondholders and public rights vested in trust in the state, while upon every true theory and exposition of his contract the rights of the public are superior to his private rights, and the rights and interests of his co-bondholders are, equally with his own to be protected by the law. The plaintiff's argument treats this matter as one of strict legal private right of an individual creditor against or to private property of an individual debtor, instead of a claim of exceptional character upon property of peculiar nature, in which private rights of others and the right of the public exist, which must be regarded and protected. . . . So, too, in relation to the other bondholders, it is manifest that each bondholder enters into contract relation with each and all of his co-bondholders. His right to appropriate the security in satisfaction of his bond in such lawful manner as he may choose, is modified by the same existent right in every other holder. His absolute right of control is limited, not only by the express provisions of the bond and mortgage, but also, in great measure, by the peculiar nature and character of the security."

It is to be noted that all of these cases involved railroad companies, and that the public interest in an expeditious and sound reorganization was a moving cause with the court in recognizing the right of the majority to control. Indeed the courts have gone far in dealing with private contract rights where public utilities are concerned. The familiar doctrine of *Fosdick* v. *Schall* [24] that the public interest requires the court to displace the prior lien of bondholders and give a preference to unsecured creditors who hold claims for "the current debts of a railroad company contracted in the ordinary course of its business, . . . to keep the railroad itself in condition to be used with reasonable safety for the transportation of persons and property" [25] needs no elaboration. Again,

[24] 99 U. S. 235, 249 (1878). It is interesting to note that the rather startling though sound doctrine of Fosdick *v.* Schall, with its seeming denial of bond-holders' constitutional rights was established by Chief Justice Waite, who had so clear an insight into the realities of corporate reorganizations. In reaching the conclusion he did in Fosdick *v.* Schall he laid stress upon the fact that the legal rights of bond-holders among themselves had to be modified as appears from the following language:

"It rarely happens that a foreclosure is carried through to the end without some concessions by some parties from their strict legal rights, in order to secure advantages that could not otherwise be attained, and which it is supposed will operate for the general good of all who are interested. This results almost as a matter of necessity from the peculiar circumstances which surround such litigation."

[25] Justice Harlan, in delivering the opinion of the court, in Southern Ry. Co. *v.* Carnegie Steel Co., 176 U. S. 257, 285 (1900).

the courts have held that the public interest involved in a railroad was such that the holders of conflicting liens arising from separate mortgages would not be allowed to tear the property apart so as to have separate sales of the constituent parts as they were strictly entitled to do.[26] This consideration of the public interest likewise demands a facile and direct method of reorganization by majority control. The public is concerned in not having a utility hobbled by a long receivership, and starved because of indiscriminate litigation between the owners, while a tremendous load of receiver's certificates accumulates, destroying, in substance, the bondholders' priorities; such conditions, obviously prevent the utility from giving efficient service. As Judge Hook said recently:

> "Moreover, the public, though not a party to the record, has an interest in every railroad reorganization, accomplished by foreclosure, of which the court should take notice." [27]

And if majority control should be observed in the reorganization of public utilities, because it is facile and time-saving, and avoids the wasting of property, it should be adopted for the same reasons in the case of the reorganization of private corporations. The interests of bondholders in private corporations — indeed of investors in corporate securities generally — would be furthered by a certain and trustworthy procedure of corporate reorganization; such an improvement in the law would enhance the value of their securities.

To be sure, the court should not draw a plan of reorganization for the parties; nor should it force bondholders to accept a plan which has not already been approved by a large majority. It should limit its activity primarily to protecting the majority in their right to control, and in ascertaining whether or not a proposed plan is fair to all concerned, and, in case of public utilities, to the public as well as to the majority and to the minority. Public interest, powerful though it is, cannot induce a court of equity to carry out a reorganization and consolidation itself by the issuance of receiver's certificates although such a plan would greatly benefit

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[26] Farmers' Loan & Trust Co. *v.* Cape Fear Ry. Co., 82 Fed. 344, 347 (1897), and on appeal to the Circuit Court of Appeals for the Fourth Circuit, 87 Fed. 392, 400 (1898). Chicago D. & V. Ry. Co. *v.* Loewenthal, 93 Ill. 433, 450 (1879); Gibert *v.* Washington City etc. Ry. Co., 33 Gratt. (Va.) 586, 609 (1880).

[27] Central Trust Co. *v.* Missouri K. & T. Ry. Co., 246 Fed. 154, 156 (1917).

the public.[28] In brief, the court during a reorganization must insure a convenient procedure to enforce contract-rights but should not make new contracts for the parties.

The decisions of the Supreme Court in the Shaw case [29] and the Shedd case [30] have not been followed by the lower federal courts, especially so far as the theory of these cases is concerned.[31] Indeed, the doctrine of the necessity of fixing an upset price in reorganizations by way of foreclosure, is a doctrine built up solely by the lower federal courts; it has arisen out of an overwhelming solicitude for minority rights and a confusion as to the duties of the chancellor under a foreclosure sale. The reasons impelling this fixing of an upset price because of the court's fear that the sale will be "chilled," are aptly stated in a decision by the Circuit Court of Appeals for the Seventh Circuit;

"At execution sales and at foreclosure sales of ordinary farms or town lots, the general public may in fact be interested as intending bidders because of their separate financial ability to purchase. It was in the consideration of such sales that the ancient and familiar rule arose. But in modern times, when vast railroad and industrial enterprises are financed by selling millions of bonds payable to bearer through the world's exchanges, a different class of sales has appeared. Courts have had to recognize that separate individual ability is not equal to the purchase and rehabilitation of a broken-down railroad. 'Reorganization' has become familiar. This means, usually, that the equity of the stockholders, if any ever existed in actual value, has vanished; that the property virtually belongs in equity to the bondholders; and that, if the bondholders will combine for the mutual protection of their equal interest, they will have a practical monopoly of the bidding. This last is so because, if all the bondholders are in the combination, it is utterly immaterial to them whether they bid the full amount of the decree or a sum that will pay only one cent on the dollar of their bonds; and therefore, by creating that masterful situation, they can force any outside combination to offer the full amount of the decree without danger or expense to themselves. Most commonly the controversy over the sale

[28] Merchants' Loan & Trust Co. *v.* Chicago Rys., 158 Fed. 927 (1907); Kneeland *v.* American Loan Co., 136 U. S. 89, 97; Lake St. El. Ry. Co. *v.* Ziegler, 99 Fed. 114, 129 (1900).

[29] Shaw *v.* Railroad Co., *supra.*

[30] First Nat. Bank *v.* Shedd, *supra.*

[31] But see decision by Justice Bradley as Circuit Justice in Duncan *v.* Mobile & O. Ry. Co., 3 Woods (U. S.) 597, 8 Fed. Cas. 25, 26 (1879).

arises when there are nonassenting bondholders. When such a controversy is on, the chancellor in our opinion not only has the right but owes the duty of being vigilant to see, on the one hand, that a dissenter be not permitted to create a maneuvering value in his bonds by opposing confirmation, and, on the other, that the majority does not use its power, unique in sales of this class, to oppress a helpless minority. Mr. Justice Brewer in *Ballentyne* v. *Smith,* 205 U. S. 285, 27 Sup. Ct. 527, 51 L. Ed. 803, said:

"'That a court of equity owes a duty to the creditors seeking its assistance in subjecting property to the payment of debts, to see that the property brings something like its true value in order that to the extent of that value the debts secured upon the property may be paid; that it owes to them something more than to merely take care that the forms of law are complied with, and that the purchaser is guilty of no fraudulent act.'" [32]

It is to be noted that the language from *Ballentyne* v. *Smith* [33] quoted above, so often used by the lower federal courts to bolster up the doctrine of an upset price, is not in point. In that case there was no reorganization involved. A small electric railway issued bonds to the amount of $50,000 secured by a deed of trust; the property cost and was worth about $78,000. On the foreclosure it was bought for $1,000; the master and the lower court advised against the confirmation of the sale and the Supreme Court of the United States confirmed this finding. In such cases, where the wronged party who seeks the chancellor's aid is either the mortgagor, who complains that he will be despoiled of his equity in the property, and subjected in addition, to an unjust deficiency judgment, or the holder of an inferior lien, or an unsecured judgment creditor, who will be deprived of property rights thereby, the chancellor can well intervene.[34] But the situation is entirely

[32] Investment Registry, Limited *v.* Chicago & M. E. Ry. Co., 212 Fed. 594, 609 (1913).

[33] 205 U. S. 285, 289 (1907).

[34] In a case, where first mortgage bondholders are seeking to buy in the property under a foreclosure sale and to exclude junior bondholders who claim that the value of the property is such that they have a substantial equity, theoretically there would be a need of fixing a value for the properties or determining an upset price. But this situation is purely theoretical, and seems never to have arisen in the books. Since the first mortgage bondholders would not impair their rights by giving junior lien-holders "residuary claims to the property," *i. e.,* third mortgage bonds, or common stock in the new corporation, they are almost always willing to do so to avoid litigation. Yet, if senior bondholders seek to exclude junior bondholders who have some equity in

different in the case of the usual foreclosure sale in aid of a reorganization; there the mortgage debtor or holders of inferior liens, as a class, are not seeking the protection of the court. It is a confusion of ideas to assert that such a foreclosure sale, because of the lack of public bidding, requires the chancellor to become a party and safeguard the minority; a foreclosure sale is not a foreclosure sale at all but merely a left-handed device to effect a reorganization.

> "For it rarely happens in the United States that foreclosures of railway mortgages are anything else than the machinery by which arrangements between the creditors and other parties in interest are carried into effect, and a reorganization of the affairs of the corporation under a new name brought about." [35]

Hence so long as the reorganization plan is fair and open to all parties, and the majority approves, the court should refuse to act.

The vice of fixing an upset price is the power it gives the minority to harass the majority, to delay proceedings, and to attempt to set aside a sale after it has been held. It is this fear of an attack upon a sale that causes counsel for a reorganization committee often to request the fixing of an upset price. So soon as it is clear that the courts will not fix upset prices, or set aside sales, or enjoin reorganization committees, or allow indiscriminate interventions, minority bondholders during a reorganization will demean themselves like minority stockholders. Only fraud or oppression — and concrete allegations and proofs not generalities ought to be required — should cause the chancellor to give heed to the minority. Indeed, the lower federal courts, instead of firmly establishing or denying the rights of a minority to have an upset price fixed, have hesitated and equivocated; the authorities are unsatisfactory; [36]

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the property, the plan of reorganization would not be a fair one and would lack the consent of a majority of all classes of bondholders; the court could well refuse to accept such a plan, and could threaten to fix an upset price. This threat and the cost of the litigation involved, as a practical matter, would force the senior lien-holders to reach an understanding with the junior lien-holders and thus the unsatisfactory guessing at a value on the property would be avoided. See COOK ON CORPORATIONS, 7 ed., note 1, § 886, pp. 3465–66.

[35] Chief Justice Waite in Canada Southern Ry. Co. *v.* Gebhard, 109 U. S. 527, 539 (1883).

[36] In the following cases an upset price has been fixed, or the right to have an upset price fixed, recognized. Blair *v.* St. Louis H. & K. Ry. Co., 25 Fed. 232, 233 (1885); Central Trust Co. of New York *v.* Washington County R. Co., 124 Fed. 813, 818 (1903); Investment Registry Limited *v.* Chicago & M. E. R. Co., 212 Fed. 594, 609 (1913);

there is needed an appreciation by the courts that foreclosure sales are merely arrangements which can be effected only by majority control under the guidance of the courts, and that the chancellor should not think primarily of minority rights and sorrows. And what is needed more than anything else is a vigorous hand by the courts in carrying out this policy.

Indefensible as the fixing of an upset price is in principle, the practical difficulties involved constitute a greater objection. By what rule should this upset price be determined? The cases where an upset price has been fixed are few in number and in hopeless confusion. In one case the court capitalized the net earnings at four per cent; [37] this would result in an unusually high upset price. In another case the court fixed the upset price at the amount of the costs of litigation and outstanding receiver's certificates; [38] this result, of course, was of no protection to the minority bond-holders. In another case a compromise figure was adopted, based upon the net earnings and the future bonding value of the properties.[39] Indeed, when one considers the confusion in the law of

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Equitable Trust Co. *v.* Western Pac. Ry. Co., 233 Fed. 335, 336 (1916); Rospigliosi *v.* New Orleans M. & C. R. Co., 237 Fed. 341, 344 (1916); Simon *v.* New Orleans T. & M. R. Co., 242 Fed. 62, 63 (1917). See also dissenting opinion of Justice Lurton in Northern Pac. Ry. Co. *v.* Boyd, 228 U. S. 482, 513 (1913); COOK, CORPORATIONS, 7 ed., § 849, note 2; SHORT, RAILWAY BONDS & MORTGAGES (1897), § 792; JONES, CORPORATE BONDS AND MORTGAGES, 3 ed., § 422. In none of these cases has the theory or necessity of fixing an upset price been considered without confusion with the case of a fraudulent sale where the mortgagors or unsecured creditors complain because the price is too low. For a good example of this confusion see the discussion in SHORT, RAILWAY BONDS, *supra*. In some of the cases the courts have felt the need of majority control, but were not called upon or were unwilling to enforce the rights of the majority in a practical way. See Simon *v.* New Orleans T. &. M. R. Co., *supra*; Investment Registry *v.* Chicago & M. E. R. Co., *supra*, etc. In Fearon *v.* Bankers Trust Co., 238 Fed. 83, 88 (1916), the Circuit Court of Appeals for the Third Circuit in refusing to set aside a sale said, "In view of these considerations — that the great majority of the bond-holders favor this sale; that all the bond-holders, whether in favor of the sale or objecting to it, will have an opportunity of sharing on equal terms in the reorganization — we are of the opinion that the court below committed no error." In Lake St. El. R. Co. *v.* Ziegler, 99 Fed. 114, 129 (1900), the court held that it would "lend all proper aid to a plan of reorganization which is fair and just"; in Conley *v.* International Pump Co., 237 Fed. 286, 287 (1915), the court denied the right of the minority to oppose a foreclosure in vigorous terms. For language somewhat *contra*, see Hollister *v.* Stewart,.111 N. Y. 644, 19 N. E. 782, 790 (1889).

[37] Central Trust Co. *v.* Washington R. R., 124 Fed. 813, 818 (1903).

[38] Blair *v.* St. Louis H. & K. R. Co., 25 Fed. 232, 233 (1885).

[39] Equitable Trust Co. *v.* Western Pac. Ry., 233 Fed. 335, 336 (1916).

public utility valuation in rate and eminent domain cases, the costly and voluminous engineering appraisals necessary to ascertain the fair value of a plant, the extremely lengthy and technical hearings, the chances of fixing a fair upset price seem negligible. Even the earnings of the property are no guide. Aside from the fact that to capitalize the earnings in the case of a public utility is generally to argue in a circle, the earnings of an insolvent corporation, without adequate capital, are usually modified by so many circumstances — unusual expenses of receivership, temporary difficulties and adversities, need of further expenditures to preserve the property — as to be of little aid. Again, it is not the fair value of the property that the court should seek; it is the fair value at a forced sale, for the bondholders as a class have brought about a foreclosure and the minority cannot in fairness force the majority to consider the sale other than a forced one. In short, the confusion of theories, the anomalous conditions, the heavy expense and costly litigation involved in valuation proceedings, show clearly the reasons why the courts in attempting to fix an upset value have simply guessed wildly and reached some figure.

Some minority bondholders of course seek to obstruct until they acquire a nuisance value and are bought out; others act in good faith and assert their right not to be forced to go into a reorganization of which they disapprove. They desire to get some of their money back and seek to place upon the majority bondholders the obligation to repay them. Obviously this is unfair; if the minority desire cash they can receive their securities under the reorganization and sell them on the market. But they have no right to insist that the majority should buy them out, directly or indirectly; or to obstruct the majority in conserving and protecting the common security.

III

The advantages of enforcing majority control by refusing to fix an upset price, are even more apparent in the case of a reorganization — indeed the usual reorganization — where there are conflicts between the liens of different classes of bonds. Frequently two or more public utility corporations, each of which has a mortgage outstanding on its separate property, is consolidated into a new company, upon the assets of which a new mortgage, and often

a third, is placed. The deeds of trust securing the underlying bond issues usually contain the conventional clause, mortgaging all the property thereafter acquired by the mortgaging corporations as additional security for the bonds issued. The new corporation, from the proceeds of the new bonds issued by it, makes extensive replacements and improvements, and adds new lands or equipment to the plant or system. The underlying bondholders claim a first lien upon all of the property of the new corporation, including this after-acquired property, and often quarrel among themselves as to their priorities thereto; the overlying bondholders assert that they hold a first lien upon all the after-acquired property. Thus a vexed legal and engineering question offers a highroad to fruitless litigation and delay.

For, although the effect of a clause mortgaging after-acquired property is in its nature clear, the precise property covered thereby is often open to doubt. Where a mortgagor agrees to mortgage any property he may acquire after the date of the mortgage, a court of equity will specifically enforce this contract to mortgage, and will therefore, without any formal performance of the agreement to mortgage, create an equitable lien which attaches to the after-acquired property so soon as it comes into existence.[40] But will equity enforce this agreement against the bondholders of the successor of the mortgaging corporation as to property acquired by this new corporation? At first glance, such a result would seem illogical; but the courts have gone to considerable lengths in holding that this equitable lien attaches to property acquired by a succeeding corporation. The Supreme Court of the United States [41] for example, has held that where the "A" railroad corporation surveyed the route for a railroad from Springfield, Illinois, to Chicago, constructing through the "X" construction company, a very small part of the road, and issued bonds, secured by a deed of trust containing an after-acquired clause, the lien of these bonds would attach to parts of the contemplated road built by the "B" corporation, the successor of "A" and also to other parts of the contemplated road built by the "C" corporation, successor of "B." The decision is somewhat confused by mesne conveyances

[40] See WILLISTON, SALES (1909), 168, also Samuel Williston, "Transfers of After-acquired Personal Property," 19 HARV. L. REV. 557.

[41] Wade *v.* Chicago, Springfield & St. Louis R. R. Co., 149 U. S. 327, 341 (1893).

through the "X" construction corporation, but the result and the reasoning give an unexpected scope to an after-acquired clause. So, too, the Supreme Court of Maine [42] has held that bonds issued by the "A" railroad corporation, secured by a deed of trust containing an after-acquired clause, will prevail over the bond issue of the succeeding "B" corporation which built part of the road, and over the bond issue of the "C" corporation, which succeeded the "A" and "B" corporations, even as to broad-gauge rolling stock purchased by the "C" corporation to be used after the narrow gauge "A" roadway had been replaced by a broad gauge line.[43]

The problems arising from an after-acquired clause are often rendered well nigh insoluble when there is doubt if additions to and extensions of, the original property, are integral parts of the property as described in the underlying mortgage, or entirely new properties not within the contemplation of the after-acquired clause of the first mortgage. The decisive factor in such a situation, in the case of a public utility, would seem to be the extent of the franchise of the original company. The intent of the parties to the mortgage as to the precise property to be covered by the after-acquired clause would, it seems, be determined by the obligation of the mortgagor to extend its service under its franchise. The Supreme Court of the United States has been called upon to define the extent of a gas company's franchise with considerable nicety.[44] Unless this guide of the profession of service by the corporation is accepted, it would seem difficult to ascertain just what property, other than replacements, the parties to the mortgage intended to include in the effect of the after-acquired clause; in the case of a private corporation, obviously, this guide is lacking. Again, the doctrine of accession, where one company adds pipes or rails to the existing system of the old company, or the questions resulting from the erection of buildings or structures by the consolidated

[42] Hamlin *v.* Jerrard, 72 Me. 62, 68 (1881).

[43] This same rule was adopted in Nat. Bank of Wilmington & Brandywine *v.* Wilmington Ry. Co., 81 Atl. 70, 73 (Delaware, 1911). See language apparently *contra* Hinchman *v.* Point Defiance Ry. Co., 14 Wash. 171, 44 Pac. 867, 872 (1896). See also Pullman's Palace Car Co. *v.* Mo. Pac. Ry. Co., 115 U. S. 587, 594 (1885); Diggs *v.* Fidelity & Deposit Co., 112 Md. 50, 75 Atl. 517, 524 (1910); New York Security & Trust Co. *v.* Louisville Eastern & St. Louis Consol. R. Co., 102 Fed. 382, 393 (1900); Harris *v.* Youngstown Bridge Co., 90 Fed. 322, 332 (1898).

[44] Russell *v.* Sebastian, 233 U. S. 195, 208 (1914).

company on land or under franchises originally held by the mortgaging company,[45] further complicate the situation. The uncertainty of the scope of an after-acquired clause, when the mortgaging company has transferred its assets, therefore, is the greatest limitation upon its effectiveness; yet, in the cases discussed before, the courts seem to have ignored that difficulty.

The engineering problems involved in segregating a unified property so as to ascertain the extent of the conflicting liens, and the difficulty of tearing the property apart in order to give each class of lien-holders their strict rights — if equity will so do — can scarcely be exaggerated. The necessity of this has been recognized by the Supreme Court of the United States[46] where the court held that this controversy as to priority of liens should be transferred from the property to the equitable fund received from the sale of the properties. Yet a new company, as a banking problem, cannot be organized effectively if its ownership is to be the subject of litigation. Such a question as this offers minority bondholders a chance to keep the property in litigation for years. The technical legal rights of dissenting overlying bondholders, if carefully examined, appear well-nigh unassailable. A reorganization plan, establishing a compromise delimitation of the extent of each mortgage lien, approved by the majority of the bondholders of each class, could always be forced upon the minority if the court refused to fix an upset price. A minority bondholder would not be inclined to litigate over the apportionment of an equitable fund if that fund be so small as to make his share insignificant. He would prefer to abide by the reorganization plan. And since it is difficult to conceive of any constitutional right in a minority bondholder to have an upset price fixed, and since he can share with the majority on an equal footing, such procedure would be a happy means of preventing litigation, and thereby facilitating a reorganization. Otherwise, if a minority bondholder has a right to have an adequate upset price fixed, he can insist upon having the property for which the price is to be fixed ascertained, and that means a heyday of litigation.

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[45] See Toledo, Delphos & Burlington R. R. Co. *v.* Hamilton, 134 U. S. 296, 297 (1890).

[46] First National Bank of Cleveland *v.* Shedd, 121 U. S. 74, 85 (1887).

IV

In what is perhaps the most vexed and unsatisfactory phase of corporate reorganization — the participation of stockholders of the insolvent corporation in the reorganization — the theory of majority control seems to offer the only solution. The most pressing problem confronting a reorganization committee is, usually, that of new funds to meet current expenses, and to provide for necessary improvements and replacements. The conventional way of raising new money, as approved by the Supreme Court of the United States,[47] is to make the old bondholders stockholders in the new corporation and to issue new first mortgage bonds. Often, such a plan cannot be forced upon the old bondholders, or will not produce enough money. The source of hope, then, is usually the old stockholders. Stockholders generally show a startling sporting propensity, and are willing to stand an assessment, and advance new funds, rather than lose forever what slender hopes they may have. Yet, the Supreme Court of the United States has placed such indistinct limitations upon the participation of stockholders in a reorganization that it is difficult to tell from the authorities what may or may not be done.

In the Monon case [48] the Supreme Court of the United States first considered the "novel and important" [49] question of the participation of a stockholder in a reorganization. Here a general creditor sought to set aside a decree of foreclosure and sale on the ground that the bondholders and stockholders of the railroad had consummated a scheme wherein they colluded to defeat all general creditors by foreclosing the mortgage of the bondholders; in other words, the scheme of reorganization, under the foreclosure, provided no place at all for the unsecured creditors, but did allow the stockholders to participate. The court held that the property was a trust fund for the benefit of all creditors, and that a scheme whereby one class of creditors was allowed nothing, and the stockholders still retained an interest in the property, could not be tolerated.

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[47] Shaw *v.* Railroad Co., 100 U. S. 605, 612 (1879). See also Ginty *v.* Ocean Shore R. R. Co., 172 Cal. 31, 155 Pac. 77, 79 (1916).

[48] Louisville Trust Co. *v.* Louisville, etc. Ry. Co., 174 U. S. 674, 681 (1899).

[49] See opinion Justice Brewer in the Monon case, *supra*.

The Monon case was followed by the famous Boyd case [50] which offers a still more serious and perplexing menace to most reorganization plans. The most striking danger in the doctrine of this case arises not merely from the uncertainty it left as to the right of stockholders to participate in a reorganization, but rather from the fact that the court held that, although Boyd, an unsecured creditor, brought his suit to upset the foreclosure sale, and the reorganization thereunder, by subjecting the property of the railroad company to a lien for his claim, nine years after the foreclosure sale had been confirmed by the court, nevertheless he could prevail. To be sure, the long litigation in a collateral suit that Boyd had been forced to undergo in order to establish his claim probably meant that the statute of limitations had not run, or that he was not barred by laches; nevertheless the case holds that so long as a reorganization contains a flaw it can never be considered the basis of fixed rights, regardless of foreclosures or confirmations of sales by solemnly entered decrees of the court.[51] Surely such is a deplorable rule; it arises from the fact that the courts view foreclosure sales as devices and will not be bound by them. The court said in the Boyd case: [52]

> "But, of course, such a transfer by stockholders from themselves to themselves cannot defeat the claim of a non-assenting creditor. As against him the sale is void in equity, regardless of the motive with which it was made. For if such contract reorganization was consummated in good faith and in ignorance of the existence of the creditor, yet when he appeared and established his debt the subordinate interest of the old stockholders would still be subject to his claim in the hands of the reorganized company. *Cf. San Francisco, & N. P. R. R.* v. *Bee*, 48 Calif. 398; *Grenell* v. *Detroit Gas Co.*, 112 Mich. 70. There is no difference in principle if the contract of reorganization, instead of being effectuated by private sale, is consummated by a master's deed under a consent decree."

The plan involved in the Boyd case, whereby the Northern Pacific Railway Company was reorganized, proceeded upon the theory that the bondholders owned the property and could do as they chose with it. Thus no provision was made for a large float-

[50] Northern Pac. Ry. *v.* Boyd, 228 U. S. 482, 498 (1913).

[51] See COOK, ON CORPORATIONS, 7 ed., § 849.

[52] Northern Pac. Ry. *v.* Boyd, 228 U. S. 482, 502 (1913).

ing debt; but the stockholders, both common and preferred, were given stock in the new company, upon condition that they paid a heavy assessment. Some eleven million dollars were raised in this way, and it was admitted that this money was essential and served as the basis of the prosperity of the new company. The unsecured creditors sought to defeat the foreclosure plan because they were excluded and the stockholders were not, but the Circuit Court held, in a decision from which no appeal was taken, that, since the assets were insufficient to pay the mortgage debt, the unsecured creditors had no claim to the property, and that, in as much as the bondholders, in reality owned the property, they could donate an interest to whomsoever they chose, including the stockholders.[53] The Supreme Court held however, years later, in the Boyd case, four judges dissenting, that it was illegal to allow the stockholders to participate when an unsecured creditor like Boyd had received nothing, and that Boyd's claim was a lien upon the property purchased "subject, however, to the mortgages placed thereon." This decision in the Boyd case was recently followed by the court in an unsatisfactory opinion written by Mr. Justice Holmes, who had dissented from the Boyd case.[54]

Certain conclusions can be drawn from the doctrine of the Boyd case, aside from the menace of allowing the court to set aside consent foreclosure decrees at any time, which will aid one in ascertaining the real problem involved. It must be admitted, first, that it is unfortunate and undesirable rigorously to prevent bondholders from allowing stockholders to participate in a reorganization where all the creditors cannot be paid in full, thus making it impossible to get money from the stockholders. Secondly, it would seem clear that the basis of the decision in the Boyd case that the court cannot tolerate the participation of stockholders in a plan of reorganization where a class of creditors are coldly and completely barred is just. The fundamental rule that debtors, *i. e.*

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[53] Paton *v.* Northern Pac. Ry. Co., 85 Fed. 838, 839 (1896).

[54] Kansas City, So. Ry. Co. *v.* Guardian Trust Co., 240 U. S. 166, 174 (1916). The decisions of the lower Federal Courts following the Boyd case cast little light upon the problem. See Mechanics & Metals Nat. Bank *v.* Howell, 207 Fed. 973, 983 (1913); Central Improvement Co. *v.* Cambria Steel Co., 210 Fed. 696, 708 (1913); Equitable Trust Co. *v.* United Box Board & Paper Co., 220 Fed. 714, 719 (1915); Western Union Tel. Co. *v.* United States & Mexican Trust Co., 221 Fed. 545, 550 (1915).

stockholders, must not defeat the just claims of their creditors, directly or indirectly, cannot be violated. To the argument that the bondholders own the property and can donate it to whom they choose, the answer is clear. Whether or not the bondholders own the property depends upon the valuation fixed upon the property by the court, an unsatisfactory guess upon which no rule should be based. In other words, here again arises the question of the upset price, the folly of a court attempting to put a special price upon a special kind of property, for which there is no market value, where no opportunity is afforded even to ascertain the facts of value involved. This truth involving a rejection of the value of an upset price, was cogently stated by Mr. Justice Lamar who delivered the opinion of the court: [55]

"The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property, for in cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether, on the day of sale the property was insufficient to pay prior encumbrances. The facts in the present case illustrate the necessity of adhering to the rule. The railroad cost $241,000,000. The lien debts were $157,000,000. The road sold for $61,000,000, and the purchaser at once issued $190,000,000 of bonds and $155,000,000 of stock on property which a month before, had been bought for $61,000,000."

Some equitable middle ground should be found reconciling, or at least delimiting, these two elements. In the Guardian Trust Company case [56] the court indicated its desire to reach some fair result in solving this problem, Mr. Justice Holmes saying: [57]

"In short while it is true that reorganization plans often would fail if the old stockholders could not be induced to come in and to contribute some fresh money, and that the necessity of such arrangements should lead Courts to avoid artificial scruples, still we are not prepared to say

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[55] Northern Pac. Ry. *v.* Boyd, 228 U. S. 482, 507 (1913).

[56] In Kansas City So. R. Co. *v.* Guardian Trust Co., 240 U. S. 166, 176 (1916), Mr. Justice Holmes uses the following language: "It is essential to inquire whether the appellant (*i. e.* the reorganized corporation), received any such property, that is, whether it got by the foreclosure more than enough to satisfy the mortgage, which was a paramount lien." This might indicate that the court was inclined to regard the fixing of an upset price as the solution of the difficulty. See Paul D. Cravath, "Reorganization of Corporations," in STETSON, LYNDE, *et al.*, SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, 198.

[57] 240 U. S. 166, 178 (1916).

that the Court of Appeals was wrong in finding that there had been a transgression of the well settled rule of equity in this case, or that it went further than to see that substantial justice should be done."

And in the Boyd case the court suggests the proper course to be followed.[58]

"This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable bonds, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it. If, however, no such tender was made and kept good he retains the right to subject the interest of the old stockholders in the property to the payment of his debt. If their interest is valueless, he gets nothing. If it be valuable, he merely subjects that which the law had originally and continuously made liable for the payment of corporate liabilities."

In brief, if the plan of organization provides a place for unsecured creditors whereby such creditors are partly or slightly paid, in cash or bonds, or allowed stock, even inferior to that of the old stockholders who advance money to the new company and can be given a priority because of that reason, and if a majority of the unsecured creditors accept this offer, and the dissenting unsecured creditors are given an equal opportunity to participate, can the minority object? Such a plan, it would seem, would contain the "fair offer" in a "just reorganization" of which the court speaks in the Boyd case. It would be fair to all because all classes of creditors would be provided for; it would allow stockholders to participate; and thus the conditions of the decision in the Boyd case would be met, and conveniences of financing not precluded. In other words, if the majority of the class excluded, or relegated to a position inferior to the participating stockholders, consent and the plan is not oppressive or unfair, can the minority of this class object? And must not the reorganization committee provide in some way for these creditors as a class?

If the majority of creditors should demand full payment of their claims, and should refuse to accept a plan of reorganization

[58] Northern Pac. Ry. *v.* Boyd, 228 U. S. 482, 508 (1913).

which provides for part payment of unsecured creditors, and also allows stockholders to participate, the court must, it seems,[59] refuse to allow stockholders to participate, unless the class of creditors is unusually small and is acting with bad faith in reliance upon their nuisance value. Then equity should, on elementary principles, refuse relief, exclude the class, and refuse to fix an upset price. The majority of any class of security holders almost always will act reasonably in order to preserve the property; the danger arises from an unreasonable minority. Such is the theory upon which the English Acts providing for arrangements are based; the soundness of this theory is shown in actual reorganization experience.

In the Boyd case the reorganization committee did acquire $14,000,000 of the unsecured claims; at what discount it does not appear. In the Guardian Trust case, a fund has been provided to buy in unsecured claims and many had been acquired. These facts indicate sharply the necessity of the rule of fair majority control urged herein. Obviously for a reorganization committee to arrogate to itself the right of paying off some unsecured creditors in part or whole, — or even the majority of the unsecured creditors, — and to ignore the rest, as was done in the Boyd case, for ignored and dissatisfied creditors brought the suit in the Paton case,[60] is an act of oppression. Merely to provide a fund, which can be withdrawn, for the purpose of buying in unsecured claims, is not enough; all classes must be given definite legal rights. The majority should control only where the plan is a fair one; and even then the majority of all classes of bondholders and unsecured creditors must consent and the plan be open to all on an equality.

Again, the court was right in holding as it did in the Boyd case that the fact that Boyd did not appear at the time of the foreclosure sale did not mean that the decree foreclosed his rights as would be true in the case of an ordinary foreclosure sale where all

[59] For, unless the rule that debtors shall not prevail over creditors is to be regarded lightly, stockholders, where creditors are not paid in full and a majority of these creditors fairly refuse to accept a plan for the participation of stockholders, cannot participate. The only alternative is to allow an additional privilege to the reorganizers and to extend them, in case they cannot get the consent of a majority of the unsecured creditors, the right to prove that the objecting creditors are unfair because of the value of the property regardless of their motives. This theory, of course, depends upon an upset price and seems too uncertain to be adopted.

[60] Paton *v.* Northern Pac. R. R., 85 Fed. 838, 839 (1896).

creditors are forever barred by the sale. Foreclosure sales as such in aid of reorganization are merely devices. They should be considered a final adjustment of all rights, as is done in England, only if they result in a complete and just financial structure erected under the supervision of the chancellor. Non-appearing security holders of all classes must be provided for. Their securities in the new company must be kept ready for them for a reasonable time. No reorganization committee fails to provide for a bondholder whose whereabouts is unknown; the same rule should be observed in the case of unsecured creditors. To be sure there is no certain means of ascertaining the amount of unsecured claims; hence a contingent fund must be set aside to pay, or provide securities for, these claims as they appear. There might be a theoretical difficulty in getting the consent of the majority of a class the extent of which is unknown; yet those creditors who fail to use due diligence in appearing, after reasonable notice by publication, can well be ignored so far as voting is concerned. If this method of majority control under a plan, providing for all parties, and approved by the court, is followed, then a foreclosure in aid of reorganization can well be considered final by the courts; the menace of the Boyd case in holding that a foreclosure decree can be opened at any time, is therefore avoided.

In short, majority control of all security holders under a fair plan of reorganization providing for, and open to all security holders, appears to offer a sound solution of the difficulties arising from the doctrine of the Boyd case.

V

How can majority control under a fair plan be provided for, assuming that the courts will not readily establish such a doctrine in its full scope? Provisions in the deed of trust are usually relied on. Deeds of trust, as now drawn up, are voluminous and wonderful documents; yet the conventional provisions as to majority control found therein are open to grave criticism and seem futile and useless. In the first place, unless the courts favor majority control they will not be bound by any covenants in the mortgage which seem to them oppressive, any more than they will in the case of oppressive covenants in an ordinary mortgage. Again,

general grants of power to the majority will be construed closely, because of uncertainty and because of the nature of the relationship involved. No careful lawyer drawing a deposit agreement, whereby securities are to be deposited with a committee effecting a reorganization, fails to insert an express and concrete power to do everything possible; [61] yet general clauses in the case of deeds of trust giving the majority general powers are usually relied upon.

Thus, the conventional provision providing for a meeting of the bondholders, or their consent thereto in writing, and binding the minority absent or present, to do anything the majority decide upon, so far as reorganizations are concerned, appears to miss the mark. An effort has been made to show that majority control is not the sole essential of a reorganization; the plan provided must be a fair one, and a means must be afforded of determining that the plan is fair.[62] Surely the majority cannot draw up the plan, accept it, and also determine that it is fair. Reorganizations, since they involve large property rights, absent parties, and also represent a fundamental change in the nature of the corporation, and since the public interests are often concerned, should be carried out publicly under the protection and guidance of a court as is done in England. And it seems clear that the courts will not allow general provisions in a deed of trust to deprive them of this duty. Definite provisions can well be inserted in a deed of trust providing that, upon default of the mortgagor corporation, the trustee must propose, or accept at the request of two thirds of the security holders of all classes, a fair plan of reorganization providing for and open to all classes of security holders; that upon the written consent of a majority of each class, and determination of the court before whom the foreclosure is pending that the plan is fair to all security holders,[63] each and every bondholder surrenders all rights to have an upset price fixed, and agrees to accept securities under the reorganization, similar to those

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[61] See, as to the dangers of general provisions. United Water Works, Limited *v.* Omaha Water Co., 164 N. Y. 41, 58 N. E. 58, 59 (1900); SHORT, RAILWAY BONDS & MORTGAGES (1897), § 28.

[62] See COOK ON CORPORATIONS, 7 ed., § 833.

[63] Possibly it is difficult to confer jurisdiction upon a court to determine a condition precedent — the fairness of the plan. Yet the court should void the surrender of the right to fix an upset price if the plan is fraudulent or oppressive. Thus the result is the same.

accepted by the majority creditors, in satisfaction of all rights. In short the vital and determining feature of a reorganization is the fixing of an upset price; definite provisions should be made for the surrender of that right where the plan is fair to all concerned. Such a provision is essential; the failure of deeds of trust to provide for the relinquishment of this right to have an upset price fixed is indeed startling.

This phase of corporation law, however, should not be left to the parties to agree upon and codify as part of their contract. Like other phases of corporation law, where certainty and definiteness of rights are vital, the subject is peculiarly one requiring codification by statute.[64] A short section added to the corporation laws of the various states, and especially to the Federal Judicial Code, would complete our statutory corporation law and do much to establish the value and safety of corporate securities.[65] Possibly arguments for such an improvement in the law are visionary; yet the codification of other branches of corporation law, and the improvements by statute in England, afford ground for hope.

Samuel Spring.

BOSTON, MASS.

[64] Kentucky has a statute in force enacted in 1896 which follows the English procedure and requires the minority to assent without the intervention of a foreclosure. To avoid constitutional difficulties, the act provides that contract rights arising before the passage of the act are not to be affected thereby. (KENTUCKY STATUTES, CARROL, 1915, § 771.) No other state, evidently, has passed such a statute. See, generally, SHORT, RAILWAY BONDS & MORTGAGES (1897), § 878, note 1.

[65] In 1896, Mr. Moorfield Story, in his address as President of the American Bar Association, discussed the Kentucky statute, *supra*, and suggested that other states adopt it. Mr. Story trenchantly pointed out the defects in our law governing reorganization, describing the "existing practice, of which the country has had a bitter experience within the last few years and of which the railroad cases furnish the most conspicuous examples." "Reorganization of Railway and Other Corporations," REPORT OF AMERICAN BAR ASSOCIATION (1896), Vol. XIX, page 240. His comments are equally true to-day, twenty-two years later.